Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:CTR:HAR:TL-N-4131-00
CJSantaniello

date: JUL 17 2000

to: Chuck Stewart, Team Leader, LMSB

from: District Counsel, Connecticut-Rhode Island District, E. Hartford

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subject: Advisory Opinion - [redacted]

THIS DOCUMENT INCLUDES CONFIDENTIAL INFORMATION SUBJECT TO THE ATTORNEY-CLIENT AND DELIBERATIVE PROCESS PRIVILEGES AND SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE SERVICE, INCLUDING THE SUBJECT TAXPAYER. THIS DOCUMENT ALSO CONTAINS TAX RETURN INFORMATION SUBJECT TO THE PROVISIONS OF I.R.C. § 6103 AND ITS USE WITHIN THE SERVICE SHOULD BE LIMITED TO THOSE WITH A NEED TO REVIEW IT.

We are responding to your July 6, 2000 verbal request for assistance. During a meeting on that date, Case Manager Charles Stewart asked for our legal advice regarding whether [redacted] (the partnership) should be treated as a TEFRA partnership for its partnership year [redacted] and, therefore, subject to the unified partnership audit provisions of I.R.C. §§ 6221 through 6233.[1] For the reasons set forth below, to date, the partnership, which is exempt as a "small partnership" from the TEFRA partnership provisions under section 6231(a)(1)(B)(i), has not made a proper election to have those provisions apply for the partnership year in question. Thus, any administrative or judicial proceedings for that year would be determined at the partner, rather than the partnership level under the unified partnership audit and litigation procedures. As also discussed below, however, the partnership has until October 12, 2000 to make a timely election under Treas. Reg. § 301.6231(a)(1)-1T.

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[1] All statutory section references are to the Internal Revenue Code in effect during the years at issue.

Issue

Whether the partnership, by answering "yes" to Question 4, Schedule B of its [redacted] Form 1965 ("Is this partnership subject to the consolidated audit procedures of sections 6221 through 6233?"), made a valid election to be subject to the unified partnership and litigation audit procedures.

Facts

[redacted], a calendar year partnership, was formed on [redacted]. Its three partners were [redacted] ([redacted]), [redacted] ([redacted]), and [redacted] ([redacted]). At that time, [redacted] and [redacted] were subsidiaries of [redacted], which filed a consolidated return for the year at issue. [redacted] was and still is a subsidiary of [redacted]. It is believed that the partners contributed personal property in return for their partnership interests.

During [redacted], [redacted] and [redacted] received partnership distributions totaling $[redacted] and $[redacted], respectively. Because the distribution to each partner exceeded the amount of its capital contribution, the partners treated the distributions as returns of capital, rather then taxable distributions.

In [redacted], [redacted] sold [redacted] to [redacted] for an unknown sum. The examination team believes that this sale, together with the partners' subsequent receipt of purportedly nontaxable distributions, constitutes a disguised sale of the property contributed to the partnership by the two [redacted] subsidiaries. The fact that the information relating to the substantive issue is limited at this juncture is immaterial to the procedural question discussed herein.

Neither [redacted], [redacted], nor [redacted] reported the transaction on their respective [redacted] Forms 1120. The statute of limitations for [redacted] consolidated return year expires on [redacted] (three years from the filing date). The corporation has signed statute extensions for the years [redacted] through [redacted] through [redacted].

The partnership filed its [redacted] Form 1065 on [redacted]. On that form, the partnership reported a loss of approximately $[redacted], which flowed through to the three partners. On Question 4, Schedule B of the Form 1965, the partnership indicated "yes" to the question whether it was

subject to the unified partnership audit provisions of sections 6221 through 6231 and also designated a Tax Matters Partner for that partnership year.

To date, the Examination Division has not commenced an examination of the partnership's Form 1065. The statute of limitations for the partnership's [redacted] Form 1065 expires on [redacted] under section 6229(f).

Discussion

Section 6221 provides that, except as otherwise provided, the tax treatment of any partnership item shall be determined at the partnership level. The term "partnership" is defined in section 6231(a)(1)(A)(i) as any partnership required to file a return under section 6031(a).[2]

One exception to section 6221, however, appears in section 6231. Under section 6231(a)(1)(B)(i), effective for partnership taxable years ending after August 5, 1997, the unified partnership audit provisions do not apply to a "small partnership" unless the partnership elects to have those provisions apply. The term "small partnership" consists of any partnership having ten or fewer partners, each of whom is an individual (other than a nonresident alien), a C corporation,[3] or an estate of a deceased partner. Section 6231(a)(1)(B)(i).

The provisions of section 6231(a)(1)(B)(i) apply in this case because the partnership year [redacted] ends after August 5, 1997 and the partnership has only three partners, all of which are C corporations. Consequently, although the partnership qualifies for the small partnership exception, it may nevertheless elect to have its partnership items determined at the partnership level under section 6231(a)(1)(B)(ii).

Elections under section 6231(a)(1)(B)(ii) are made by attaching an election statement to the partnership return for the first tax year for which the election is made. Treas. Reg. § 301.6231(a)(1)-1T(b)(2). The election must be identified as an election under section 6231(a)(1)(B)(ii), be signed by all persons who are partners of the partnership during the

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[2] In this case, we believe that [redacted] elected to be taxed as a partnership, as evidenced by the filing of the [redacted] Form 1065.

[3] Prior to August 5, 1997, the small partnership exception did not extend to partnerships with C corporations as partners.

partnership taxable year to which the return relates, and be filed at the time and place prescribed for filing the partnership return.

In this case, the partnership's [redacted] Form 1065 was the first return filed by the partnership. Thus, there is no document to corroborate the partnership's statement on line 4 of Schedule B that it was subject to the unified partnership audit provisions of sections 6221 through 6233. In the absence of a proper election, therefore, the partnership is not presently subject to the TEFRA audit provisions. As discussed below, however, the partnership may make a timely election to be treated as a TEFRA partnership anytime before October 12, 2000.

Although the partnership has not filed an election statement, as required by Treas. Reg. § 301.6231(a)(1)-1T(b)(2), it could argue that it substantially complied with the requirement by checking "yes" to question 4, Schedule B of the Form 1065. In this regard, it is well established that substantial compliance with a regulation is sufficient when the regulation requires a procedural detail that does not go to the essence of the statute. If the requirement goes to the essence of the statute, it is mandatory and must be met. Young v. Commissioner, 783 F.2d 1201, 1205 (5th Cir. 1986), aff'g 83 T.C. 831 (1984); American Air Filter v. Commissioner, 81 T.C. 709, 719 (1983); Penn-Dixie Steel Corp. v. Commissioner, 69 T.C. 837, 846 (1978); Sperapani v. Commissioner, 42 T.C. 308, 331-32 (1964).

To determine whether a regulatory provision setting forth how an election is to be made goes to the essence of the statute, and therefore must be literally complied with, the following factors must be considered:

1. whether the taxpayer's failure to comply fully defeats the purpose of the statute;

2. the relationship of the regulatory requirement to other provisions;

3. the terms of the underlying statute;

4. whether the sanction imposed on the taxpayer for the failure to comply is excessive and out of proportion to the default;

5. whether the taxpayer attempts to benefit from hindsight by adopting a position consistent with his original action or omission;

6. whether the Commissioner is prejudiced by the untimely election; and

7. whether the regulation provided with detailed specificity the manner in which an election was to be made.

American Air Filter Co., 81 T.C. at 719-20; Valdes v. Commissioner, 60 T.C. 910, 913 (1973).

Whether the partnership's statement on Line 4 of Schedule B substantially complies with the requirement in Treas. Reg. § 301.6231(a)(1)-1T(b)(2) is doubtful. The requirement of an election statement is designed to provide unequivocal notice to the Service that the partnership intends to be treated as a TEFRA partnership. In the absence of an express election, the partners and the partnership could later take positions inconsistent with that of having previously made an election. See Knight-Ridder Newspapers v. United States, 743 F.2d 781, 795 (11th Cir. 1984) (holding that the taxpayer's failure to make an express election would leave room for it to later argue that it had never intended to make an election and that it was, therefore, not required to accept the burdens of having made it).

For example, if the Service were to treat the partnership as a TEFRA partnership and ultimately issue an FPAA to the Tax Matters Partner, the partners could later argue, notwithstanding the statement in Schedule B, that the partnership was not subject to TEFRA because it never attached the required election statement to its [redacted] Form 1065. Similarly, if the Service were to issue notices of deficiency to the partners under section 6212 attributable to adjustments to partnership items, the partners could conversely maintain that the notices are invalid because the partnership had previously elected to be subject to TEFRA, and that the Service did not act reasonably considering the statement in Schedule B. Accordingly, we do not believe that the partnership substantially complied with the requirement in Treas. Reg. § 301.6231(a)(1)-1T(b)(2) to file an election statement.

If the Service were to make a determination before the partnership made a proper election under Treas. Reg. § 301.6231(a)(1)-1T, its determination that the partnership either is or is not a TEFRA partnership, the partnership could not contest that procedural determination if the Service acted reasonably. Section 6231(g) allows the Service to reasonably rely on the face of the partnership return when determining whether TEFRA applies. Under that provision, if, on the basis of the partnership return for a taxable year the Secretary reasonably determines that the TEFRA provisions do (or do not)

apply but such determination is erroneous, then TEFRA does (or does not) apply to such partnership and its items for such taxable year or to partners of such partnership. Although section 6231(g) is effective for taxable years ending after August 5, 1997, existing case law has reached the same conclusion. See Harrell v Commissioner, 91 T.C. 242 (1988) and Z-Tron v. Commissioner, 91 T.C. 258 (1988) (both addressing the same share requirement).

In this case, the Service could reasonably determine, based on the face of the partnership's [redacted] Form 1065, that the TEFRA provisions do not apply. First, the Form 1065 in question is the first return filed by this partnership, formed in [redacted]. Although the partnership indicated on Line 4, Schedule B that it was subject to the unified partnership audit provisions of sections 6221 through 6233, there is no indication on the face of the return, other than this bare assertion, that would corroborate that statement.

Finally, as previously noted, although the partnership has not yet properly elected to be subject to TEFRA for its partnership year [redacted] under section 6231(a)(1)(B)(ii), it may still do so for that year under Treas. Reg. § 301.6231(a)(1)-1T, which provides:

> However, for partnership taxable years for which a partnership return is to be filed before ninety days after the date final regulations under this section are published in the Federal Register the partnership may file the statement described in the preceding sentence on or before the date which is one year before the date specified in section 6229(a) for the expiration of the period of limitations with respect to that partnership (determined with regard to extensions of that period under section 6229(b)).

(emphasis added).

Applying Treas. Reg. § 301.6231(a)(1)-1T to the facts in this case, the partnership may still make a proper election under section 6231(a)(1)(B)(ii) by filing the election statement anytime before October 12, 2000 because the regulations under section 6231 are not yet final. In this case, the partnership filed the Form 1065 on [redacted]. Thus, under section 6229(a), the Service has three years, or until [redacted], to assess tax attributable to partnership items. The partnership, therefore, has until October 12, 2000 to make a proper election.

Conclusion

For the foregoing reasons, the partnership has not yet made a proper election under section 6231(a)(1)(B)(ii) to have the TEFRA provisions apply for its partnership year [redacted]. Thus, any administrative or judicial proceedings for that year would be determined at the partner, rather than the partnership level. The partnership has, however, until October 12, 2000 to make a timely election under Treas. Reg. § 301.6231(a)(1)-1T. In the event the Service decides to proceed at the partner level, we suggest that you immediately inform the partnership of its failure to make a proper election and that it may do so on or before October 12, 2000. Such notice will avoid any argument by the partners or the partnership that the Service engaged in deceptive or deceitful practices, as well as negate any argument that the Service's determination that the TEFRA provisions do not apply was not reasonable under section 6231(g)(2).

We are simultaneously submitting this memorandum to the National Office for post-review and any guidance they may deem appropriate. Consequently, you should not take any action based on the advice contained herein during the 10-day review period. We will inform you of any modification or suggestions, and, if necessary, we will send you a supplemental memorandum incorporating any such recommendation.

Please call Carmino J. Santaniello at (860) 290-4075 if you have any questions or require further assistance.

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By: _____
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